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## A Variety of Factors Contribute to Cable Rate Increases

During the preceding 5 years, cable rates have increased approximately 40 percent—well in excess of the approximately 12 percent increase in the general rate of inflation. We found that a number of factors contributed to the increase in cable rates. These factors include increased expenditures on programming, infrastructure investments, and costs associated with customer service. On the basis of data from 9 cable operators, programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years.

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## Rates for Cable Service Have Increased Rapidly, Far Outpacing the General Rate of Inflation

FCC data indicate that the average monthly rate subscribers are charged for the combined basic and expanded-basic tiers of service rose from \$26.06 in 1997 to \$36.47 in 2002—a 40 percent increase over the 5 years. This rate of increase is much greater than the general rate of inflation, as measured by the Consumer Price Index (CPI), which rose 12 percent over the same period. The CPI cable television subcategory index also shows cable rates increasing much faster than inflation, although the rise is somewhat less than the rise in rates as reported by FCC, likely because the Bureau of Labor Statistics (BLS) calculates this index in a way that takes into account the increasing number of channels offered over time. As figure 2 shows, the CPI cable television subcategory index rose just under 30 percent in the same 5-year time frame.

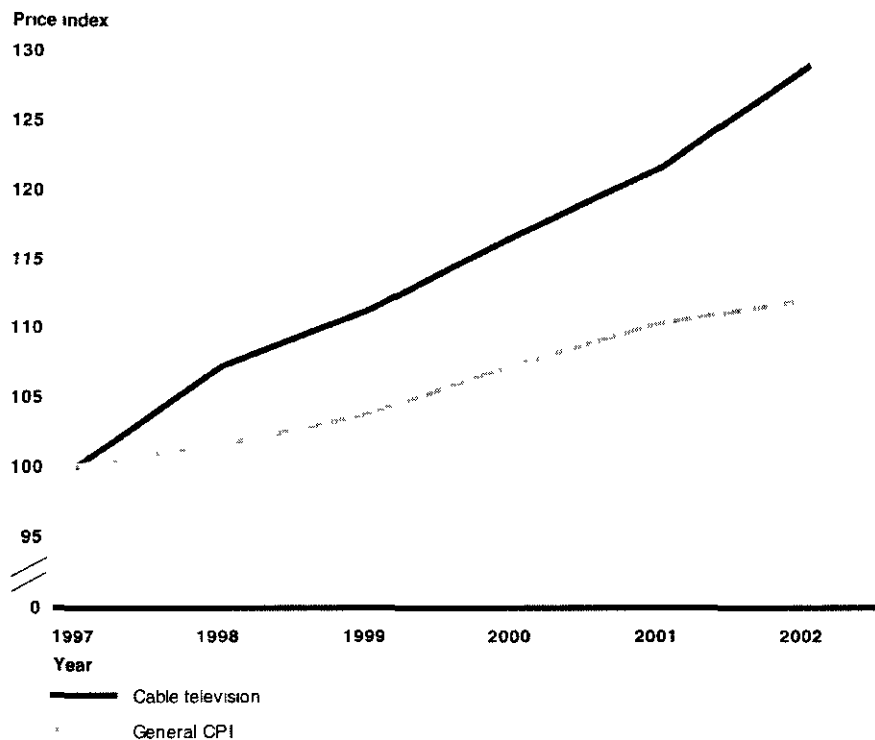
Several cable industry officials told us that the general rate of inflation is not an appropriate gauge for evaluating cable rates. In particular, these officials told us that a more appropriate comparison against which to evaluate the price increases for cable television would be other services that have the same kind of cost factors, such as other forms of entertainment media and services, which have also experienced significant price increases in recent years. Moreover, several cable industry representatives told us that on a per-channel basis, the increase in cable rates has not been as dramatic because cable operators are providing additional cable networks.<sup>25</sup> However, it is not clear how meaningful cable rates reported on a per-channel basis are since subscribers cannot purchase cable service on a per-channel basis. Alternatively, in a recent analysis, a researcher found that because the number of hours subscribers

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<sup>25</sup>In addition to the BLS cable television subcategory index, FCC also reports the price per channel over time. Contrary to the BLS index indicating that cable prices increased just under 30 percent, FCC found that the price per channel rose by about 5 percent during this 5-year span.

view cable networks has increased, cable rates, adjusted for this additional viewing, have actually declined.<sup>26</sup>

**Figure 2: Change in the General and Cable Television Consumer Price Indexes, 1997 – 2002**



### Increases in Expenditures on Cable Programming Contribute to Higher Cable Rates

As discussed in the previous section, one important factor contributing to higher cable rates is cable operators' increased costs to purchase programming from cable networks. Ten of the 11 cable operators, 8 of the 15 cable networks, and all of the financial analysts we interviewed told us that higher programming costs contribute to rising cable rates. On the basis of financial data supplied to us by 9 cable operators, we found that these operators' yearly programming expenses, on a per-subscriber basis, increased from \$122 in 1999 to \$180 in 2002—a 48 percent increase. Using

<sup>26</sup>See Wildman, S S *Assessing Quality-Adjusted Changes in the Real Price of Basic Cable Service* Michigan State University September 10, 2003

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data from Kagan World Media, we found that the average fees cable operators must pay to purchase programming (referred to as license fees) increased by 34 percent from 1999 to 2002.<sup>27</sup> Although these estimated increases are somewhat different—which probably occurs because the data underlying these analyses are from different sources—both methods appear to reflect a substantial rise in programming expenses over the past few years.

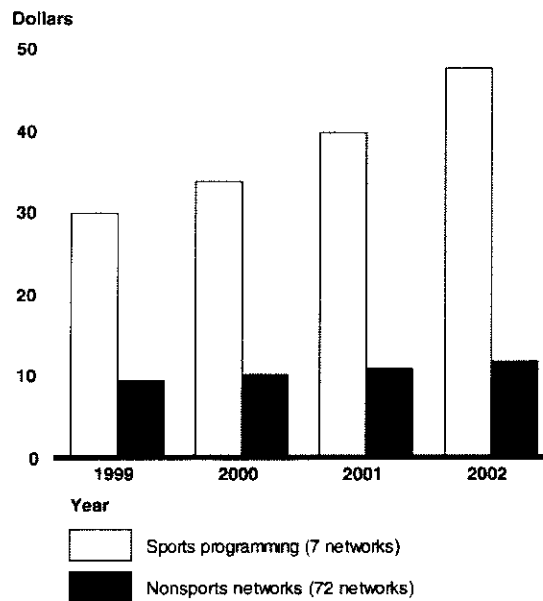
Almost all of the cable operators we interviewed cited *sports* programming as a major contributor to higher programming costs. On the basis of our analysis of Kagan World Media data, the average license fees for a cable network that shows almost exclusively sports-related programming increased by 59 percent in the 3 years between 1999 and 2002.<sup>28</sup> Conversely, for the 72 nonsports networks, the average increase in license fees for the same period was approximately 26 percent. Further, the average license fees for the sports networks were substantially higher than the average for other networks. See figure 3 for a comparison of the average license fees for sports programming networks compared with nonsports networks from 1999 to 2002.

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<sup>27</sup>Since the rates that cable networks negotiate with their clients/affiliates are confidential, we do not know the actual fees cable operators pay to carry the networks. We thus relied on license fee data compiled by Kagan World Media.

<sup>28</sup>The seven national sports networks that we included in our analysis were ESPN, ESPN Classic, ESPN2, FOX Sports Net, The Golf Channel, The Outdoor Channel, and the Speed Channel

**Figure 3: Average Monthly License Fees per Subscriber—Sports Programming Networks v. Nonsports Networks, 1999 – 2002**



Source: GAO analysis of Kagan World Media data.

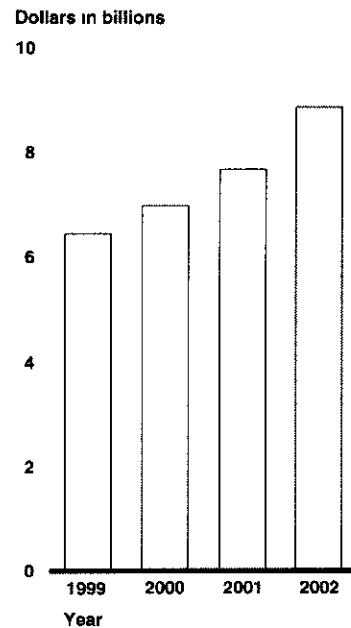
The cable network executives we interviewed cited several reasons for increasing programming costs. We were told that competition among networks to produce and show content that will attract viewers has become more intense. This competition, we were told, has bid up the cost of key inputs (such as talented writers and producers) and has sparked more investment in programming. Most notably, these executives told us that networks today are increasing the amount of original content and improving the quality of programming generally. Also, some executives cited the increased cost of sports rights<sup>29</sup> and increased competition among networks for the broadcast rights of existing programming (such as syndicated situation comedies). As figure 4 shows, data from Kagan World

<sup>29</sup>Two of the three sports leagues with whom we spoke told us that the cost of sports rights, paid by networks to the leagues, has not increased faster than the cost of other network programming in the last couple of years. However, representatives of the leagues did note that the cost to sports networks of producing sports programming is increasing because these are live events that require complex and costly production.

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Media indicate that of 79 cable networks we analyzed, expenditures by these networks to produce programming increased from \$6.47 billion in 1999 to \$8.90 billion in 2002, or by about 38 percent.<sup>30</sup>

**Figure 4: Expenditures by 79 Cable Networks to Produce Programming, 1999 – 2002**



Source: GAO analysis of Kagan World Media data.

Although programming is a major expense for cable operators, several cable network executives we interviewed also pointed out that cable operators offset some of the cost of programming through advertising revenues. In fact, 3 cable networks with whom we spoke said that they believe at least *half* of the license fees cable operators pay to carry their networks are recouped through the sale of the local advertising time that cable networks allow the cable operators to sell, which typically amounts to 2 minutes per hour. According to industry data, cable operators received over \$3 billion from the sale of local advertising time in recent

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<sup>30</sup>For this analysis, we only used networks included in the Kagan publication that had financial data for the years 1999 to 2002. Later in this report, we have other analyses that use more of the networks included in the Kagan publication. In those analyses, we did not need 4 historical years of data.

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years. Local advertising dollars account for about 7 percent of the total revenues in the 1999 to 2002 time frame for the 9 cable operators that supplied us with financial data. For these 9 cable operators, gross local advertising revenues—before adjusting for the cost of inserting and selling advertising—amounted to about \$55 per subscriber in 2002 and offset approximately 31 percent of their total programming expenses.<sup>31</sup> However, we were told that only the larger cable operators gain significant revenues from the sale of advertising, and that smaller cable operators generally do not sell as much local advertising because it is not always cost-effective for them to do so. In fact, even the larger cable operators do not sell all of the local advertising time that is available to them because there are significant costs of selling television ads.

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### Several Other Factors Appear to Contribute to Higher Rates for Cable Service

In addition to higher programming costs, the cable industry has incurred other increased costs. For example, according to industry sources, the cable industry spent over \$75 billion between 1996 and 2002 to upgrade its infrastructure by replacing degraded coaxial cable with fiber optics and adding digital capabilities (see fig. 5). As a result of these expenditures, FCC reported that there have been increases in channel capacity; the deployment of digital transmissions; and nonvideo services, such as Internet access and telephone service.<sup>32</sup> Five of the 11 cable operators, 9 of the 15 cable networks, and three of the five financial analysts we interviewed said investments in system upgrades contributed to increases in consumer cable rates. For example, one network with whom we spoke said that the major cause of recent cable rate increases is the cable industry's capital improvements. Although these upgrades benefit cable subscribers by expanding the number of cable networks available and improving picture quality, much of the benefit of infrastructure improvements accrue to subscribers who purchase new, advanced services, such as broadband Internet access. One expert who commented on our report noted that there is no need for cable operators to pass on costs associated with infrastructure upgrades to subscribers purchasing basic and expanded-basic service because, by his calculations, these costs

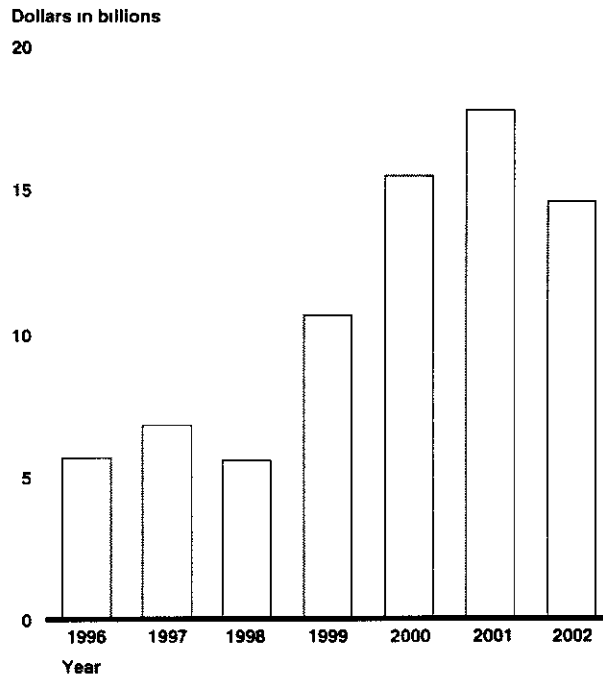
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<sup>31</sup>Advertising sales revenues net of expenses incurred to insert and sell local advertising would offset a lower percentage of cable operators' programming expenses

<sup>32</sup>For example, FCC reported that approximately 74 percent of cable systems had system capacity of at least 750 MHz, and that approximately 70 percent of cable subscribers were offered high-speed Internet access by their cable operator in 2002.

are almost fully offset by increases in revenues for digital tier and advanced (e.g., cable modem) services.

**Figure 5: Cable Industry Infrastructure Expenditures, 1996 – 2002**



Source: Kagan World Media data as reprinted on NCTA's Web site

Another factor contributing to higher cable rates is cable operators' increased expenditures on customer service. NCTA said that the industry is paying more in labor costs because it has sought better-educated and more highly trained employees to provide customer support for the new services that the cable operators are offering. Additionally, customer service is now typically available to cable subscribers 24 hours a day, 7 days a week. Three of the five financial analysts we interviewed agreed that increased customer service costs contributed to increases in cable rates, while 5 of the 11 cable operators we interviewed said increases in customer service, labor costs, or both contributed to higher cable rates.

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## Programming Expenses and Infrastructure Investment Appear to Be Primary Contributors to Cable Rate Increases

On the basis of financial data from 9 cable operators, we found that annual subscriber video-based revenues—that is, revenues from basic, expanded-basic, and digital tiers; pay-per-view; installation charges; and other revenues such as equipment rental—increased approximately \$79 per subscriber from 1999 to 2002. By 2002, revenues per subscriber averaged \$561, or \$47 per month. During this same period, programming expenses increased approximately \$57 per subscriber. Depreciation expenses on cable-based property, plant, and equipment—an indicator of expenses related to infrastructure investment—increased approximately \$80 per subscriber during the same period. Although this may indicate that the marginal profits for the video business have been declining—which is consistent with what we were told during our interviews with financial analysts—there are two important caveats to this conclusion. First, depreciation expenses (and therefore infrastructure investment) represent a joint (or common) expense for both video-based and Internet-based services. Because these expenses are associated with more than one service, it is unclear how much of this cost should be attributed to video-based services. Second, cable operators are enjoying increased revenues from these nonvideo sources. For example, revenues from Internet-based services increased approximately \$74 per subscriber during the same period. Thus, even if video profit margins have been in decline, this does not imply that overall profitability of cable operators has declined.

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## Some View Ownership Affiliations as an Important Indirect Influence on Cable Rates

Several industry representatives and experts we interviewed told us that they believe ownership affiliation may also influence the cost of programming and thus, indirectly, the rates for cable service. We found that there are two primary ownership relationships that some believe influence the cost of cable programming: relationships between cable networks and cable operators, and relationships between cable networks and broadcasters. To understand the nature of these ownership relationships, we analyzed the ownership of 90 cable networks that are carried most frequently on cable operators' basic or expanded-basic tier (see fig. 6). Of these 90 cable networks, we found that approximately 19 percent were majority-owned (i.e., at least 50 percent owned) by a cable operator.<sup>33</sup> For example, cable operators have ownership interests of at

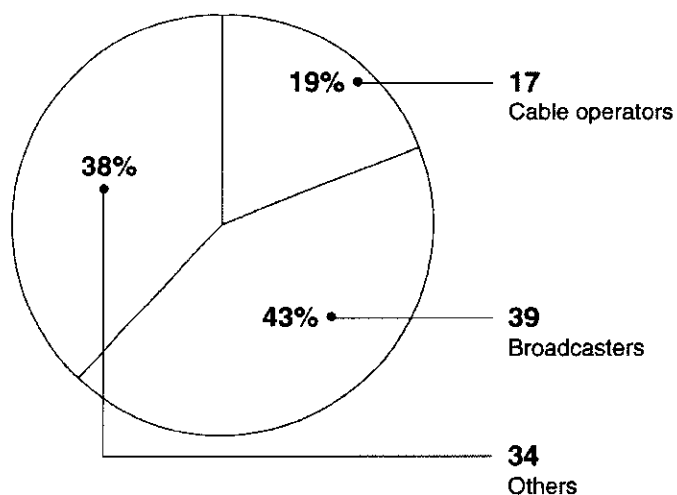
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<sup>33</sup>We also performed the analysis reported in this section with a 20 percent ownership affiliation threshold—that is, we considered a network as “owned” by a broadcast network or cable operator if the network was at least 20 percent owned by either of these types of providers. With this ownership threshold, our findings were nearly identical to those reported here.



least 50 percent in such widely distributed cable networks as TBS, TNT, CNN, AMC, and the Cartoon Network.<sup>34</sup> We also found that approximately 43 percent of the 90 networks were majority-owned by a broadcaster. For example, broadcasters have ownership interests of at least 50 percent in such widely distributed cable networks as ESPN, FX, MSNBC, and MTV. The remaining 38 percent of the networks are not majority-owned by broadcasters or cable operators.

**Figure 6: Ownership Affiliation of the 90 Most Carried Cable Networks**



Source: GAO analysis of Kagan World Media data.

Note: Cable networks were assumed affiliated if the ownership interest was 50 percent or greater.

Despite the view held by some industry representatives with whom we spoke that license fees for cable networks owned by either cable operators or broadcasters tend to be higher than fees for other cable networks, we did not find this to be the case. In particular, we found that cable networks that have an ownership affiliation with a broadcaster did not have, on average, higher license fees (i.e., the fee the cable operator pays to the cable network) than cable networks that were not majority-

<sup>34</sup>Only 3 of the large cable operators are majority owners of national cable networks.

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owned by broadcasters or cable operators.<sup>35</sup> We did find that license fees were statistically higher for cable networks owned by cable operators than was the case for cable networks that were not majority-owned by broadcasters or cable operators. However, when using a regression analysis (our cable license fee model) to hold constant other factors that could influence the level of the license fee, we found that ownership affiliations—with broadcasters or with cable operators—had no influence on cable networks' license fees.<sup>36</sup> We did find that networks with higher advertising revenues per subscriber (a proxy for popularity) and sports networks received higher license fees.

Industry representatives we interviewed also told us that cable networks owned by cable operators or broadcasters are more likely to be carried by cable operators than other cable networks. There was a particular concern expressed to us regarding *retransmission consent agreements*. These agreements often include, as part of the agreement between cable operators and broadcasters for the right of the cable operator to carry the broadcast station, a simultaneous agreement to carry one or more broadcast-owned cable networks. Many representatives from cable operators and several independent (nonbroadcast) cable networks told us that because the terms of retransmission consent agreements often include carriage of broadcast-owned cable networks, cable operators sometimes carry networks they might otherwise not have carried, and this practice can make it difficult for independent cable networks to be carried by cable operators. Alternatively, representatives of the broadcast networks told us that, to their knowledge, cable networks had not been dropped nor were independent cable networks unable to be carried by cable operators because of retransmission consent agreements. Further, these representatives told us that they accept cash payment for carriage of the broadcast station, but that cable operators prefer to carry broadcast-owned cable networks in lieu of a cash payment.

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<sup>35</sup>License fees received by broadcaster-affiliated networks were higher than those received by cable networks that were not majority-owned by broadcasters or cable operators, but the difference was not statistically significant. Moreover, when sports networks were eliminated from the analysis, the average level of license fee was almost identical across these two groups.

<sup>36</sup>In the cable license fee model, we regressed the average monthly license fee for 90 cable networks on a series of variables that might influence the license fee. See appendix I for a list of variables included in that model.

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On the basis of our cable network carriage model—a model designed to examine the likelihood of a cable network being carried—we found that cable networks affiliated with broadcasters or with cable operators are more likely to be carried than other cable networks. In particular, we found that networks owned by a broadcaster or by a cable operator were 46 percent and 31 percent, respectively, more likely to be carried than a network without majority ownership by either of these types of companies. Additionally, we found that cable operators were much more likely to carry networks that they themselves own. A cable operator is 64 percent more likely to carry a cable network it owns than to carry a network with any other ownership affiliation. Appendix V provides a detailed discussion of this model.

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### Several Factors Generally Lead Cable Operators to Offer Large Tiers of Networks Instead of Providing À La Carte or Minitier Service

Most cable operators with whom we spoke provide subscribers with similar tiers of networks, typically the basic and expanded-basic tiers, which provide subscribers with little choice regarding the specific networks they purchase. Adopting an à la carte approach, where subscribers could choose to pay for only those networks they desire, would provide consumers with more individual choice, but could require additional technology and impose additional costs on both cable operators and subscribers. Additionally, this approach could alter the current business model of the cable network industry wherein cable networks obtain roughly half of their overall revenues from advertising. A move to an à la carte approach could result in reduced advertising revenues and might result in higher per-channel rates and less diversity in program choice. Because of this reliance on advertising revenues by cable networks, most cable networks require cable operators to place their network on widely distributed tiers. A variety of factors—such as the pricing of à la carte service, consumers' purchasing patterns, and whether certain niche networks would cease to exist with à la carte service—make it difficult to ascertain how many consumers would be better off and how many would be made worse off under an à la carte approach. Creating a greater number of smaller tiers could cause many of the same technological and economic concerns as an à la carte approach.

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### Most Cable Operators Offer Similar Bundles of Networks

The 11 cable operators that we interviewed adopt very similar strategies for bundling networks into tiers of service. These cable operators offer their subscribers the following tiers of service: basic tier (11 operators), expanded-basic tier (11 operators), digital tier (11 operators), and premium services (7 operators). Five of the 11 cable operators offer the same or similar tiers of service to subscribers in all their franchise areas. The remaining 6 cable operators offer different tiers of service among their

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franchise areas; we were told that these differences are generally the result of the cable operators acquiring franchises with different tiering strategies.

Using data from FCC's 2002 cable rate survey, we also examined the networks included in the basic, expanded-basic, and digital tiers of service. With basic tier service, subscribers receive, on average, approximately 25 channels, which include the local broadcast stations.<sup>37</sup> The expanded-basic tier provides, on average, an additional 36 channels. With a digital tier, subscribers receive, on average, 104 channels. In general, to have access to the most widely distributed cable networks—such as ESPN, TNT, and CNN—most subscribers must purchase the expanded-basic tier of service.

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### Concerns Exist about a Lack of Subscriber Choice

The manner in which cable networks are currently packaged has raised concern among policy makers and consumer advocates about the lack of consumer choice in selecting the programming they receive. Under the current approach, it is likely that many subscribers are receiving cable networks that they do not watch. In fact, a 2000 Nielsen Media Research Report indicated that households receiving more than 70 networks only watch, on average, about 17 of these networks. The current approach has sparked calls for more flexibility in the manner that subscribers receive cable service, including the option of à la carte service, in which subscribers receive only the networks that they choose and for which they are willing to pay. Additionally, an organization representing small cable operators recently released a report advocating an à la carte approach because they believe it will mitigate the ability of broadcast networks to gain carriage agreements for their cable networks through the retransmission consent process.<sup>38</sup>

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<sup>37</sup>Representatives of a broadcast organization told us that the digital local broadcast signals are sometimes carried on a digital tier.

<sup>38</sup>See The Carmel Group, *The Telecom Future of Independent Cable ACA Member Concerns and Issues* (Carmel-by-the-Sea, CA May 2003), a report prepared for the American Cable Association

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## An À La Carte Network Offering Could Impose Costs on Cable Subscribers and Operators

If cable operators were to offer all networks on an à la carte basis—that is, if consumers could select the individual networks they wish to purchase—additional technology upgrades would be necessary in the near term. In particular, subscribers would need to have an *addressable converter* box on every television set attached to the cable system. Today, the networks included on the basic and expanded-basic tiers are usually transmitted throughout the cable system in an unscrambled fashion. Because most televisions in operation today are *cable ready*, a cable wire can usually be connected directly into the television and the subscriber can view all of the networks on those tiers. An addressable converter box—which serves to unscramble any scrambled networks—is only needed if the subscriber chooses to purchase networks that the cable operator transmits in a *scrambled* fashion, as is usually the case for networks placed on digital tiers, certain premium movie channels, and pay-per-view channels.<sup>30</sup>

If all networks were offered on an à la carte basis, cable operators would need to scramble all of the networks they transmit to ensure that subscribers are unable to view networks they are not paying to receive. Under such a scenario, addressable converter boxes, which enable the operator to send messages from the cable facility to the box to indicate which networks the subscriber is purchasing and thus allowed to watch, would need to be connected to all television sets attached to the cable system. The addressable converter box would unscramble the signals of the networks that the subscriber has agreed to purchase. The need for an addressable converter box deployment could be costly. According to FCC's 2002 survey data, of the franchises that responded to the survey and provided cost data on addressable converter boxes, the average monthly rental price for a box is approximately \$4.39. For homes that have multiple television sets, the expense for these boxes could add up—the extra cost for a home that needs to add three addressable converter boxes would be about \$13.17 a month at current prices.

Although cable operators have been placing addressable converter boxes in the homes of customers who subscribe to scrambled networks, many homes do not currently have addressable converter boxes or do not have them on all of the television sets attached to the cable system. For example, a representative of 1 cable operator we interviewed indicated

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<sup>30</sup> Sometimes certain cable networks are transmitted unscrambled and *trapping* devices are used outside of the customer's home to keep networks that the home has not purchased from transmitting to the customer's televisions. Thus trapping technology would not be economically viable in an à la carte regime.

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that most of its subscribers do not have addressable converter boxes. A representative of another cable operator stated that only 40 percent of its subscribers have addressable converter boxes. Conversely, 1 operator told us that nearly three out of four of its subscribers do have at least one addressable converter box in place, and that the number of homes with a box will only continue to increase. Addressable converter boxes are becoming more commonly deployed as more customers subscribe to digital tiers. Since cable operators may move toward having a greater portion of their networks provided on a digital tier in the future, these boxes will need to be deployed in greater numbers. Moreover, consumer electronic manufacturers have recently submitted plans to FCC regarding specifications for new television sets that will effectively have the functionality of an addressable box within the television set. Once most customers have addressable converter boxes or these new televisions in place, the technical difficulties of an à la carte approach would be mitigated. Several experts that we spoke with offered a wide divergence of views on how long it would be before addressable converter boxes and/or new televisions with built-in boxes are fully deployed in all American homes.

In addition to the subscriber costs of converter boxes, cable operators also would incur costs to monitor and manage an à la carte approach. Cable operators likely would have to add additional customer service and technical staff to deal with the increased number of transactions that would occur under an à la carte regime. One cable network representative we interviewed indicated that an à la carte regime would be a substantial undertaking for the cable operators. For example, this network representative told us that a cable operator offering 150 channels of à la carte programming could have its subscribers choosing all different numbers of networks, which would mean that subscribers would be spending much longer periods of times on the telephone with customer service staff.

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### Cable Networks Often Specify Placement on the Basic or Expanded-Basic Tier

Even if cable operators desired to offer customers a wider variety of bundles of services or even à la carte service, most contracts negotiated between cable networks and cable operators prohibit these alternatives. All 11 cable operators and four of five financial analysts that we interviewed told us that program contracts generally specify the tier that the network must appear on, or the contract establishes a threshold percentage of subscribers that must be able to see a network—which effectively requires the same tier placements. For example, one individual responsible for negotiating program contracts for cable operators noted

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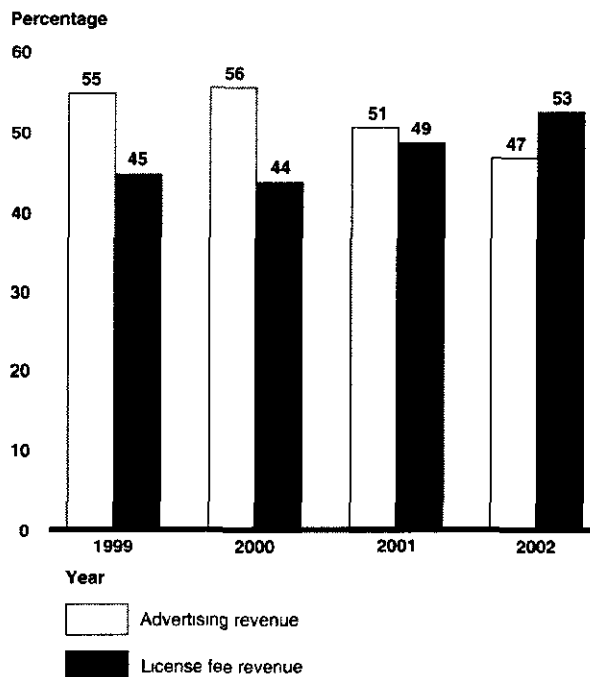
that all of the top 40 to 50 networks specify that their networks appear on either the basic or expanded-basic tier. We also reviewed sample contracts for 2 cable networks, one contract specified that the network appear on the basic or expanded-basic tier and the other contract specified "the most widely subscribed level of service." We were told that cable networks include these provisions in their contracts because their business models are developed on the basis of a wide distribution of their network.

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### **Economic Characteristics of the Cable Network Market Are a Constraint to an À La Carte Approach**

If cable subscribers were allowed to choose networks on an à la carte basis, the economics of the cable network industry could be altered, and, if this were to occur, it is possible that cable rates could actually increase for some consumers. In particular, we found that cable networks earn much of their revenue from the sale of advertising that airs during their programming. For example, 3 of the 15 cable network representatives we interviewed indicated that they receive approximately 60 percent of their revenue from advertising. Our analysis of information on 79 networks from Kagan World Media indicates that these cable networks received nearly half of their revenue from advertising in 2002. The majority of the remaining revenue is derived from the license fees that cable operators pay to networks for the right to carry their signals. Figure 7 provides a breakdown of the relationship in recent years between advertising revenues and license fee revenues on the basis of data from Kagan.

**Figure 7: Percentage of Cable Network Advertising Revenue Compared with License Fee Revenues for 79 Cable Networks, 1999 – 2002**



Source: GAO analysis of Kagan World Media data.

Note: Although cable networks have other sources of revenues, advertising and license fee revenues comprise the vast majority of cable network revenues.

To receive the maximum revenue possible from advertisers, cable networks strive to be on cable operators' most widely distributed tiers. In other words, advertisers will pay more to place an advertisement on a network that will be viewed, or have the potential to be viewed, by the greatest number of people. According to cable network representatives we interviewed, any movement of networks from the most widely distributed tiers to an à la carte format could result in a reduced amount that advertisers are willing to pay for advertising time because there would be a reduction in the number of viewers available to watch the networks. To compensate for any decline in advertising revenue, network representatives contend that cable networks would likely increase the license fees they charge to cable operators. In particular, we were told by many cable networks that under an à la carte system, the cost burden of cable television would become less reliant on advertising revenues and much more reliant on *license fees* that would likely be passed on to



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consumers. For example, one cable network representative estimated that to compensate for the loss of advertising revenue in an à la carte scenario, the network would have to raise its monthly license fee from the current monthly rate of \$0.25 per subscriber to a level several fold higher—possibly as much as a few dollars per subscriber per month. Additionally, four of the five financial analysts we interviewed also stated that license fees would increase under an à la carte approach. At the same time, if cable networks see advertising revenues decline, they will also likely take steps to reduce production costs, because cable operators might be unwilling to accept increases in license fees to fully offset the decline in advertising revenues. As such, it is not clear whether license fees would need to completely offset any declines in advertising revenues.

Because increased license fees, to the extent that they occur, are likely to be passed on to subscribers, it appears that subscribers' monthly cable bills would not necessarily decline under an à la carte system. The cable networks that we interviewed generally told us that they believe that an à la carte approach would not reduce cable rates for most subscribers. In fact, representatives of 7 cable networks noted that costs to subscribers could actually increase under an à la carte system, while 6 networks said that subscribers might pay about the same monthly bill but would likely receive far fewer channels. Conversely, for subscribers who purchase only a few cable networks, rates would likely decline under this approach because they would only have to pay for the limited number of networks that they choose to purchase. Thus, an à la carte approach would provide consumers with greater control over their cable choices, even if, on average, consumer bills did not decline.

Most of the cable networks we interviewed also believe that programming diversity would suffer under an à la carte system because some cable networks, especially small and independent networks, would not be able to gain enough subscribers to support the network. For example, one network told us that under an à la carte system, fewer networks would remain financially viable and new networks would be less likely to be developed. Three of the cable operators and four of the five financial analysts we interviewed also said that smaller networks or those providing *specialty* programming would be hurt the most by an à la carte system. A number of the cable networks indicated that launching a new network under an à la carte system would be very difficult. Similarly, according to NCTA, an à la carte approach could result in the disappearance of many networks and could undermine the prospects for any new basic cable networks. Further, if an à la carte system resulted in limited subscribers

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and decreased advertising revenue, several networks said the quality of programming available might be adversely impacted.

The manner in which an à la carte approach might impact advertising revenues, and ultimately the cost of cable service, rests on assumptions regarding customer choice and pricing mechanisms. In particular, the cable operators and cable networks that discussed these issues with us appeared to assume that many—if not most—customers, if faced with an à la carte selection of networks, would choose to receive only a limited number of networks. This assumption is consistent with the data on viewing habits—as previously mentioned, a recent study has shown that most people, on average, watch only about 17 networks. Nevertheless, under an à la carte scenario, cable companies may price large packages of networks in a way that provides an incentive for subscribers to choose a wide number of networks. Additionally, under this approach, cable operators may choose to price cable services in an entirely different way. One option suggested was that, similar to common pricing schemes in the electric and natural gas industries, subscribers might pay a flat charge for the connection to the cable operator's system plus additional charges for each network the subscriber chooses to purchase. This could result in subscribers purchasing only a few channels paying a higher rate per channel than subscribers purchasing many channels. One of the issues that some industry representatives discussed with us concerned the *value* consumers place on networks they do not typically watch. While two experts suggested that it is not clear whether more networks are a benefit to subscribers, others noted that subscribers place value in having the opportunity to occasionally watch networks they typically do not watch. Thus, there are a variety of factors that make it difficult to ascertain how many consumers would be made better off and how many would be made worse off under an à la carte approach. These factors include how cable operators would price their services under an à la carte system; the distribution of consumers' purchasing patterns; whether niche networks would cease to exist, and, if so, how many would exit the industry; and consumers' true valuation of networks they typically do not watch.

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**Creating Additional Tiers of Service Is More Feasible, but Economic and Technological Constraints Would Also Apply**

Another alternative to the à la carte approach that has been discussed is a move to minitiers, under which subscribers would choose small tiers of programming that are grouped by genre (such as sports, news and information, and general entertainment). Although industry representatives told us that this approach might be more viable than an à la carte approach, we were also told that all of the issues associated with an à la carte regime would also apply to minitiers. Representatives of 8 of

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the 15 cable networks we interviewed indicated that the creation of additional tiers would be a disadvantage to the cable industry. Four cable network representatives stated that increasing the number of tiers would result in the same outcome as an à la carte system: a decline in cable network advertising revenue that would force networks to increase their license fees to cable operators, which would result in higher cable rates. Six of the 11 cable operators we interviewed also noted that a minitier approach would also require more deployment of addressable converter boxes. Finally, a representative of 1 cable operator told us that after experimenting with genre tiers in the past, the operator determined that this was not a successful strategy. This representative stated that subscribers felt the cable operator was forcing them to buy many tiers, since a typical household wanted to see one or more networks in several of the tiers.

However, officials representing 5 of the 11 cable operators we interviewed indicated that the tier concept might be viable in the case of sports programming. A representative of 1 cable operator indicated that a sports tier would be appropriate because sport fans are loyal customers and the cost of sports programming is very high. A representative of another cable operator noted that creating a sports tier should be an option, but that other types of programming would not work on separate tiers. Recently, several regional sports networks have been placed on sports-only tiers in the New York City metropolitan area.<sup>40</sup>

Alternatively, representatives from two major sports leagues and a sports network do not believe that a sports-only tier is necessary, and some of these representatives did not believe such a tier would be viable. One important objective of the major sports leagues is to obtain the widest distribution of their games as possible. Therefore, many games appear either on broadcast television or on cable networks carried on the basic or expanded-basic tier. To ensure this wide distribution of their games, the major sports leagues include provisions in their contracts with cable networks that specify carriage of their games on a tier with broad distribution. A representative of a sports network said that if their network were offered on a sports-only tier, the nature of the network would

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<sup>40</sup>Recently, the Yankees Entertainment and Sports (YES) network was placed on a sports-only tier, with Madison Square Garden and FOX Sports Net New York, on selected Cablevision systems in the New York City metropolitan area following a lengthy dispute between YES and Cablevision. Subsequently, YES was offered on an à la carte basis on Time Warner Cable franchises in New York.

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change. In fact, representatives of the three leagues with whom we spoke said that if sports networks were on a sports-only tier, the leagues would not want to sell the right to carry certain events on those networks since it would likely not be available to most viewers.<sup>41</sup> One of these three representatives said that under this scenario, sports-only networks might cease to exist and any sports on cable would only be placed on general entertainment networks that provide variety programming—similar to broadcast networks. Finally, representatives from two of the sports leagues and a sports network said that there is no reason to believe that removing the sports networks from the expanded-basic tier would result in any substantial reduction in the rate for expanded-basic tier cable service. When two cable operators in the New York City metropolitan area moved regional sports networks to a separate tier, these companies lowered the expanded-basic cable rate by only 50 cents to a dollar.<sup>42</sup>

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## Industry Participants Have Cited Certain Options That May Address Factors Contributing to Rising Cable Rates

In recent years, there has been concern about the rapidity of cable rate increases. As we previously noted, cable rates have risen by about 40 percent in the last 5 years, far outstripping increases in the general rate of inflation. Several approaches for addressing the rise in cable rates have been put forth. These approaches can be grouped into the following two main categories: (1) the control of rates through regulation and (2) the promotion of lower rates through market mechanisms, such as through greater competition.

Some consumer groups have pointed to the lack of competition as evidence that reregulation needs to be considered. One representative of a consumer group noted that regulation might be the only alternative to mitigate increasing cable rates and cable operators' market power. For example, one consumer group has recommended, among a variety of options, returning authority to reregulate cable rates to local and state governments. However, some experts expressed concerns about cable regulation after the 1992 Act. First, some academic critics believe that cable regulation lowered the quality of programming, discouraged investment in new facilities, and imposed administrative burdens on the

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<sup>41</sup>One sports league also requires its cable network carriers to arrange for all cablecast games to be simulcast (subject to league sell-out rules) on free over-the-air television in the home cities of the participating clubs.

<sup>42</sup>In one case, the cable operator simultaneously added one or two other networks to the expanded-basic tier.

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industry and regulators. Second, according to these same critics, there is no strong evidence that cable rates were significantly constrained during that regulated era. Finally, regulation today could be considerably more complex than it was 11 years ago. Today, video providers use varied platforms (cable, DBS) to provide an array of communication services, including video service, Internet access, and video on demand. A regulatory scheme would need to consider which services and providers to regulate, and how to allocate the common costs of a communications network in a regulatory context across the various services provided.

Alternatively, taking steps to promote competition could help to reduce or slow the growth of cable rates by leveraging the normal workings of the marketplace. In those few local markets where a second wire-based provider exists, we found that cable rates are about 15 percent lower than local markets without this competition. Moreover, even though the influence of DBS on cable rates is minor, our current finding—in contrast to our earlier study and earlier studies by FCC that did not find such an effect—is that the presence of DBS does help to lower cable rates slightly. This may indicate that as more households subscribe to DBS service, cable operators will ultimately respond by reducing rates. Below, we discuss options that have been suggested for addressing the cable rate issue. We note that in this overview, we are neither making any specific recommendations regarding the adoption of any of these options, nor suggesting that this list is a necessarily comprehensive review of possible options.

*Program access issues.* The 1992 Act includes provisions aimed at, among other things, enhancing competition in the subscription video industry. As required by the act, FCC developed rules—commonly referred to as the *program access rules*—which were designed in part to ensure that cable networks that have ownership relationships with cable operators (i.e., vertically integrated cable operators) generally make their satellite-delivered programming available to competitors. Since 1992, some entering companies and consumer groups have stated that current program access rules are not broad enough to provide assurances that entrants can obtain necessary programming. In particular:

- Some have expressed concern that the law is too narrow because it applies only to the *satellite-delivered programming* of vertically integrated cable operators. In recent years, some regional cable networks owned by cable operators have been delivered to their cable facilities through wires—that is, they are not satellite delivered. When this is the case, the cable operator need not make the programming available to

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competitors. Additionally, although it is not clear how widespread this practice is in local markets across the country, a recent report by a consumer group raised concerns that it could become more prominent at a national level.<sup>43</sup> Although questions have been raised about this issue—which has come to be called the terrestrial loophole—FCC has pointed out that the statute is specific in that the program access rules apply only to satellite-delivered programming

- Although the program access rules generally prohibit exclusive contracts for programming of vertically integrated cable operators, these rules do not prohibit exclusive contracts between a cable operator and an independent cable network.<sup>44</sup> Some operators entering the market believe that some programming may not be available to them because large incumbent cable operators have secured such exclusive arrangements. Given these concerns, some have suggested that changes in the statutory program access provisions might enhance the ability of other providers to compete with the incumbent cable operators. However, others have noted that altering these provisions could reduce the incentive for companies to develop innovative programming. That is, we were told that companies may have less incentive to invest in certain new programming if they are not able to market that programming through their own distribution channels on an exclusive basis.<sup>45</sup>

*Promoting wireless competition.* The medium used to provide video services over wireless platforms—radio spectrum—is a scarce and congested resource. DBS operators have stated that they are currently not able to provide local broadcast stations in all 210 television markets in the United States because they do not have adequate spectrum to do so while still providing a wide variety of national networks.<sup>46</sup> DBS companies

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<sup>43</sup>U.S. Public Interest Research Group, *The Failure of Cable Deregulation: A Blueprint for Creating a Competitive, Pro-Consumer Cable Television Marketplace* (Washington, D.C. August 2003)

<sup>44</sup>Under the Communications Act, the prohibition on exclusive contracts enacted as part of the program access provisions in the 1992 Act were set to sunset in October 2002 unless FCC determined the rules were still necessary. In 2002, FCC extended the prohibition until October 2007 because the commission determined that the prohibition continues to be necessary

<sup>45</sup>In July 2003, FCC adopted a Notice of Inquiry asking for comment on a variety of issues related to competition in the video market. One of the issues related to program access issues

<sup>46</sup>Recently, DIRECTV announced that it would provide local broadcast stations in all 210 television markets by 2008

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gained the right to provide these local stations in 1999, and this has been important in enabling them to compete more effectively with locally based cable operators. However, as part of the so-called *carry one, carry all* provisions, these companies are required to provide *all* local broadcast stations in markets where they provide any of those stations. According to executives at the two primary DBS companies, if DBS companies only provided the local stations that they view as desired by their subscribers, they might more quickly provide local broadcast stations in more markets, thereby rendering DBS a more effective competitor to cable. However, any modifications to the DBS carry one, carry all rules would need to be examined in the context of why those rules were put into place—that is, to ensure that all broadcast stations are available in markets where DBS providers choose to provide local stations. In fact, a U.S. Court of Appeals found that certain government interests promoted by the carry one, carry all provisions applicable to DBS providers are sufficient to justify this requirement under a First Amendment analysis.<sup>47</sup> Additionally, any review of these rules would need to take into account how they relate to other similar requirements, including, for example, *must-carry* requirements for the cable industry as well as how must carry will be applied to cable and DBS in the coming digital age. As with many complex policy issues, balancing what are often conflicting considerations is very complex.

*Retransmission consent issues.* In the 1992 Act, the Congress created a mechanism, known as retransmission consent, through which local broadcast station owners (such as local ABC, CBS, Fox, and NBC stations) could receive compensation from cable operators in return for the right to carry their broadcast stations. Prior to the 1992 Act, cable operators could retransmit local broadcast stations without approval of the broadcasters and without compensation. As cable operators began to carry more cable networks that competed with broadcast networks for viewers and associated advertising revenues, broadcasters argued that it was important for them to be able to receive compensation for retransmission of their stations. The retransmission consent provisions included in the 1992 Act allow local broadcast stations and cable operators to negotiate for

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<sup>47</sup>*Satellite Broadcasting and Communications Association v FCC*, 275 3d 337 (4th Cir 2001) cert Denied 536 U S 922 (2002)

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payment or some other form of compensation in exchange for the cable operator's right to carry broadcast networks.<sup>48</sup>

Today, few retransmission consent agreements include cash payment for carriage of the local broadcast station; rather, agreements between some large broadcast groups and cable operators generally include provisions for carriage of broadcaster-owned cable networks. We were told that, after the passage of the 1992 Act, the cable industry indicated its reluctance to pay for carriage of local broadcast stations—which they had previously been carrying free of charge. The negotiations for retransmission consent at that time quickly turned to examining carriage of broadcaster-owned cable networks as compensation for the right to carry the local broadcast station. Both the Congress and FCC had indicated that carriage of broadcast-owned cable networks would be a possible way for broadcasters to receive compensation for carriage of broadcasters' over-the-air stations. A variety of parties with whom we spoke mentioned specific broadcast-owned cable networks (such as ESPN2 and MSNBC) that were launched as part of retransmission consent agreements during the 1990s.

One concern that was expressed to us regarding retransmission consent relates to its influence on the carriage decisions of cable operators. In particular, many representatives from cable operators and several independent (nonbroadcast) cable networks told us that because the terms of retransmission agreements often include the carriage of broadcast-owned cable networks, cable operators sometimes carry networks they otherwise might not have carried. Several of the cable networks we spoke with noted that this practice can make it difficult for independent cable networks to gain carriage, particularly in the case of new networks. Alternatively, representatives of the broadcast networks told us that they did not believe that cable networks had been dropped or that independent cable networks could not gain carriage because of retransmission consent agreements. Further, these representatives told us that they accept cash payment for carriage of the broadcast signal, but that cable operators tend to prefer carriage options in lieu of a cash payment. Broadcast executives also told us that the retransmission process has been very important in preserving free over-the-air television.

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<sup>48</sup>Each local broadcast station has the right to negotiate for retransmission or to assert must-carry status. Under must carry, the cable operator is required to carry a local broadcast station, but can do so without paying any compensation.



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Several of the industry representatives with whom we met also expressed concern that ownership relationships between broadcast networks and cable networks could lead to higher cable rates for consumers. Although we did not find that license fees are higher when such an ownership relationship exists, we did find that cable networks owned by broadcast networks are more likely to be carried on cable systems than networks not owned by broadcasters or by cable operators.<sup>49</sup> (See app. V for a discussion of our carriage model). As such, the influence of retransmission consent on consumer rates is not clear, since these rates could be affected by the carriage patterns.

Certain parties with whom we met advocated the removal of the retransmission consent provisions and told us that this may have the effect of lowering cable rates.<sup>50</sup> However, other parties have stated that such provisions serve to enable television stations to obtain a fair return for the retransmitted content they provide—which they believe was not the case prior to 1992. Moreover, these industry representatives noted that retransmission rules help to ensure the continued availability of free television for all Americans. Currently, there is a petition pending before FCC that asks for a review of the impact of retransmission consent.

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## Conclusions

In the last decade, the subscription video industry has undergone dramatic changes. The regulatory and competitive environments have both evolved; cable rates have been regulated and later partially deregulated; and limited wire-based competition has been supplanted by nationwide competition from satellite-based companies. It appears that this evolution has created problems for FCC's monitoring and reporting on the industry. As mandated by the Congress, FCC prepares a yearly report on cable rates in the United States. But, aspects of how information for the report is collected—such as the cost factors underlying cable rate increases—are closely associated with the earlier, regulated era of the cable industry. For example, information on cost changes underlying cable rate increases are reported to FCC on a survey form that requires the cost factors and rate changes to balance. Because rates and costs need not balance in an unregulated environment, cable franchise representatives filing out the

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<sup>49</sup>We also found that cable networks owned by cable operators are also more likely to be carried than networks not owned by broadcasters or cable operators.

<sup>50</sup>One possible option would be to replace the retransmission consent provisions with a must-carry right

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form made accommodations in their answers that may have compromised the accuracy of the cost data they were reporting. Similarly, maintaining current information on the effective competition status of cable operators under FCC's current process has proven difficult. Some expected competitors have emerged but did not fully deploy their networks and, in some cases, discontinued service altogether, and DBS companies—which were not yet providing service in 1992—have thrived, but information on their market participation is not readily available on a local level. We found that because FCC's current process does not provide for updates to the status of effective competition, some designations do not appear to reflect current competitive conditions.

In the face of the rapid evolution of the subscription video industry, it remains important for accurate, current, and relevant information to be available to the Congress and FCC. Both the Congress and FCC monitor and provide oversight of this industry, for which FCC's report can serve as an important input. Additionally, FCC's report can provide information relevant to the Congress, as it considers important policy decisions, including the regulation of cable rates and/or services, media consolidation, and the convergence of video, voice, and data services. Lacking reliable information, the Congress and FCC face the challenge of performing monitoring and oversight, as well as making important policy decisions, without the benefit of important price, cost, and competition information. As such, it is important for FCC's report to provide accurate, current, and relevant information about the cable industry.

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## Recommendations for Executive Action

To improve the quality and usefulness of the data that FCC collects on cable television rates and competition in the subscription video industry, we recommend that the Chairman of the FCC take the following actions:

- take immediate steps to improve the cable rates survey by (1) including more detailed, standardized instructions and examples for how to calculate the cost changes that the cable operators experienced in the previous year and (2) eliminating the requirement for the cost increases to sum to the change in rates and
- review the commission's process for maintaining the status of effective competition among franchises in order to keep these designations more up to date.

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## Agency Comments and Our Evaluation

We provided a draft of this report to FCC for comment. FCC had two key comments on the draft report. First, FCC stated that they are taking steps to redesign their survey questionnaire in an attempt to obtain more accurate information. Second, FCC questioned on a cost/benefit basis the utility of adopting a revised process to keep the status of effective competition in franchises up to date. We believe that providing the Congress with reliable information on cable rates and competition is important, and that improving the accuracy of effective competition designations would help to accomplish this. We recognize that there are costs associated with FCC's cable price survey, and we recommend that FCC examine whether cost-effective alternative processes exist that would enhance the accuracy of its effective competition designations. FCC's comments are contained in appendix VI, along with our responses to those comments.

We also provided a draft of this report to several industry participants and other experts for their review and comment. In particular, we provided the draft to representatives of Consumers Union, the Consumer Federation of America, the American Cable Association, the National Association of Telecommunications Officers and Advisors, the National Association of Broadcasters, the National Cable and Telecommunications Association, the Satellite Broadcasting and Communications Association, Walt Disney Company, the National Broadcasting Company, Viacom, and the News Corporation. The comments received covered a broad range of issues and each groups' comments are summarized in appendix VII. In addition, these groups provided clarifications to the draft report. As appropriate, we made changes in our report that are based on the broad comments summarized in appendix VII as well as the technical clarification provided to us by these parties.

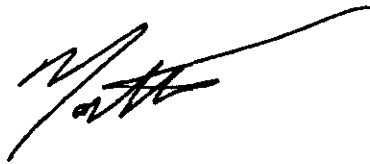
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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to interested congressional committees; the Chairman, FCC; and other interested parties. We will also make copies available to others upon request. In addition, this report will be available at no cost on the GAO Web site at <http://www.gao.gov>.

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If you or your staff have any questions concerning this report, please contact me on (202) 512-6670 or at [goldsteinm@gao.gov](mailto:goldsteinm@gao.gov). Key contacts and major contributors to this report are listed in appendix VIII.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'M. Goldstein', with a long horizontal flourish extending to the right.

Mark L. Goldstein  
Director, Physical Infrastructure Issues